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Foreclosing on the Subprime Loan Crisis: Why Current Regulations Are Flawed and What Is Needed to Stop Another Crisis from Occurring

While the federal government claims "[o]wning a home is part of the American dream,"[1] the housing boom of the late 1990s and early 2000s and the resulting increase in home prices made it difficult for individuals to finance the purchase of a home, particularly for those with low income or poor credit.[2] In response, many mortgage lenders began offering loans in greater amounts to those higher-risk borrowers, on terms more favorable to the lender and less favorable to the borrower. Such "subprime" loans helped higher-risk borrowers purchase homes or refinance existing loans while providing higher fees and interest rates to lenders to compensate for the additional risk those borrowers represented.

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1 BD. OF GOVERNORS OF THE FED. RESERVE SYS., INTEREST-ONLY MORTGAGE PAYMENTS AND PAYMENT-OPTION ARMS—ARE THEY FOR YOU? 1 (2006), http://www.federalreserve.gov/pubs/mortgage%5Finterestonly/mortgage_interestonly.pdf.

2 *Id.*

Such loans quickly became big business, as the subprime loan market grew from $35 billion in 1994 to $665 billion in 2005.[3] Between 1998 and 2006, lenders loaned more than $2 trillion in subprime home loans.[4] In recent years, however, such unfavorable loan terms have caused large numbers of borrowers to default on their loans, resulting in a swelling of foreclosures. The steadily growing number of foreclosures has caused many businesses to fail and continues to cause a large number of individuals to lose their homes.

Existing regulations have failed to prevent or remedy the subprime loan crisis and, if left unchanged, will fail to prevent a similar crisis from reccurring in the future. As a result, lawmakers and regulators in Washington have suggested several remedial measures to deal with the subprime loan crisis, including the following: (1) freezing subprime interest rates;[5] (2) allowing bankruptcy judges to reduce the amount of principal and interest due on loans;[6] (3) providing for the federal government to purchase mortgages of homeowners facing foreclosure, allowing those homeowners to refinance into more affordable loans;[7] and (4) requiring that lenders issue a warrant or "negative amortization certificate" for the difference between the mortgage and a house's current resale value.[8] However, these suggestions are only quick fixes that, while helping those

[3] ELLEN SCHLOEMER, WEI LI, KEITH ERNST & KATHLEEN KEEST, LOSING GROUND: FORECLOSURES IN THE SUBPRIME MARKET AND THEIR COST TO HOMEOWNERS 7 (2006), http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf. However, since 2005, the subprime market decreased to $650 billion in 2007. Heather M. Tashman, *The Subprime Lending Industry: An Industry in Crisis*, 124 BANKING L.J. 407, 407 (2007).

[4] CTR. FOR RESPONSIBLE LENDING, SUBPRIME LENDING: A NET DRAIN ON HOMEOWNERSHIP 2 (2007), *available at* http://www.responsiblelending.org/pdfs/Net-Drain-in-Home-Ownership.pdf.

[5] Les Christie, *Clinton Calls for Subprime Rate Freeze*, CNN MONEY, Dec. 5, 2007, http://money.cnn.com/2007/12/05/real_estate/Clinton_foreclosure_prevention/index.htm.

[6] Jeanne Sahadi, *Housing Relief Bill: It Ain't Over 'Til It's Over*, CNN MONEY, Feb. 29, 2008, http://money.cnn.com/2008/02/29/news/economy/housing_stim_presser/index.htm.

[7] The Associated Press, *U.S. Moves to Free Up Funds for Homeowners*, N.Y. TIMES, Mar. 19, 2008, http://www.nytimes.com/2008/03/19/business/apee-fannie.html.

[8] Les Christie, *Mortgage Crisis: Don't Forgive Debt, Just Postpone Repayment*, CNN MONEY, Feb. 20, 2008, http://money.cnn.com/2008/02/20/real_estate/OTC_refinance_plan/index.htm.

currently in trouble, do not address the risky loan practices that caused the subprime crisis in the first place. As a result, they will not stop another crisis from occurring in the future.

This Comment examines the subprime loan market and the inadequacies of current federal and state regulations to protect borrowers. Its purpose is not only to demonstrate why current regulations are flawed, but also to show what is needed to stop the subprime loan crisis from reccurring.

Part I of this Comment describes the subprime market today and provides a general background for scrutinizing existing regulations. Part II explains the "subprime market," in which subprime loans are packaged and sold as securities to Wall Street investors. Part III examines current federal regulations and their inability to sufficiently protect borrowers from the risks that subprime loans pose. Part IV examines similar regulations at the state level, and argues that such regulations also fail to provide adequate protection.[9] Part V explains that the increase in foreclosures due to subprime loans has created a need for increased regulation. Finally, Part VI suggests what regulatory changes need to be made to protect borrowers and ensure another crisis does not occur.

I
THE SUBPRIME MARKET TODAY

Stated simply, subprime loans are loans given to individuals with poor credit on terms significantly less favorable than those offered to borrowers with better credit.[10] Lenders traditionally extended financing only to those whose credit history minimized the lender's risk,[11] and thus were only willing to extend financing to those with poor credit or low income if their risk was

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[9] These states were chosen because they show the range of regulations that exists on the state level, from Oregon's relative lack of any regulations, to California and Florida's decision to mirror federal regulations, to Minnesota's attempt to directly address the problem. My hope is that by examining these four states' laws, lawmakers will examine their own states' statutes and attempt to make changes to address the underlying problems of the subprime crisis.

[10] Sue Kirchhoff & Sandra Block, *Subprime Loan Market Grows Despite Troubles*, USA TODAY, Dec. 7, 2004, http://www.usatoday.com/money/perfi/housing/2004-12-07-subprime-day-2-usat_x.htm.

[11] *See* R. Stephen Painter Jr., *Subprime Lending, Suboptimal Bankruptcy*, 38 LOY. U. CHI. L.J. 81, 81 (2006).

compensated with higher interest rates and greater fees.[12] To harness the market those higher-risk borrowers represented, lenders in recent years began to develop new loan provisions that made such terms more attractive and allowed lower-income individuals to qualify for the financing they sought. Those provisions, which comprise "subprime" loans, include the following:

- "Teaser" loans, or Adjustable Rate Mortgages ("ARMs") containing "teaser" rates, which are loans that maintain an artificially low interest rate, usually between one and four percent,[13] for a set period of time, usually between two and three years.[14] After the introductory period expires, the interest rate is reset to a higher variable interest rate, often well above the current market rate.[15]
- "Balloon" payment provisions, which allow borrowers to make interest-only payments until the maturity date of the loan, at which time the borrower must pay off the remaining loan balance in one large lump sum.[16]
- "Negative amortization" provisions, which allow borrowers to make lower monthly payments than required to pay off both the monthly interest and principal amount. Such provisions add any unpaid amount to the principal mortgage balance,[17] thus *increasing* the total loan amount each month.
- "Piggyback" provisions, which allow borrowers unable to afford a down payment on a home to immediately take out a second mortgage ("piggybacked" onto the original loan)

12 *Id.* at 81–82.

13 *Study Assesses Possible Risks and Impacts of Mortgage Resets*, MORTGAGE NEWS DAILY, Mar. 26, 2007, http://www.mortgagenewsdaily.com/3262007_Mortgage_Resets.asp.

14 Jesse Herman, *Foreclosures Expected to Rise After Mortgage Reset*, PERSONAL HOME LOAN MORTGAGES, http://www.personalhomeloanmortgages.com/articles_mortgage_reset.asp (last visited Oct. 20, 2008).

15 *Id.*

16 *Balloon/Reset Mortgages,* FREDDIE MAC, http://www.freddiemac.com/corporate/buyown/english/mortgages/what_is/balloon_reset.html (last visited Oct. 20, 2008).

17 BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 1, at 14.

for the remainder of the balance, thus eliminating the need for a down payment.[18]

- Loans requiring no documentation, known colloquially as "liar loans," allow borrowers to state their ability to repay a loan without having to provide supporting documentation of assets or income.[19] Such "liar loans" allow lenders and brokers to offer larger loans—thus providing for more interest and fees collected at the closing of the loan—but also put the borrower at greater risk of foreclosure by enabling the borrower to qualify for a larger loan than he is able to repay.

Subprime loans often combine several of these terms together in a single loan. Because each one of the terms is risky on its own, loans combining several such terms are especially problematic and create a greater risk of foreclosure. Additionally, these terms are extremely confusing in language and effect—particularly to unsophisticated borrowers—and only add to a borrower's confusion when combined. Due to these confusing terms, borrowers often do not understand the potential risk of subprime loans.

An example of this problem is the subprime loan that Chevy Chase Bank gave Bryan and Susan Andrews.[20] Their loan included both teaser rate and negative amortization provisions. The Andrews were given a teaser rate of 1.950% with a fixed monthly payment of $701.21 for five years, at which time the payments would increase to an adjusted level of $983.49

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18 Karen M. Kroll, *Should You Jump on a Piggyback Mortgage?*, BANKRATE, July 25, 2002, http://www.bankrate.com/brm/news/mtg/20020725a.asp. Piggyback loan terms vary depending on the lender. While most lenders require a first mortgage of 80%, some will only piggyback an additional 10% or 15%, requiring the borrower to come up with a 5% or 10% down payment. Other lenders do not require a down payment at all, and will piggyback a 20% second mortgage onto the original mortgage, thus lending 100% of the cost of a new home. While lending 100% of a home's value may seem limited in risk because home values will generally increase, this approach is coming back to haunt lenders now that home values are decreasing.

19 Kenneth R. Harney, *Lies Are Growing in Loan Process*, WASH. POST, July 30, 2005, at F01, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2005/07/29/AR2005072901129.html. Liar loans are also referred to as "NINAs," which is short for "no income, no asset verification" loans.

20 *See* Andrews v. Chevy Chase Bank, FSB, 240 F.R.D. 612 (E.D. Wis. 2007).

depending on the interest rate.[21] However, the Andrews did not understand that the teaser rate only applied to the first monthly payment.[22] Thereafter, the loan allowed for negative amortization: when the interest rate increased, their $701.21 monthly payment failed to fully cover the monthly interest, and any unpaid interest was added to the principal balance of the loan. [23] As one might expect, the Andrews were shocked and angry when they noticed their principal loan balance increased, rather than decreased, each month.[24] Subprime loan provisions can be confusing for anybody; even experienced mortgage brokers may have problems understanding subprime loans and their terms.[25]

Similar to the Andrews, millions of families have in recent years taken out subprime loans, many of whom likely did not fully understand the risks involved with their loan. As a result of entering into risky loans containing confusing terms, families are increasingly losing their homes in foreclosures. This is in part due to the erosion of home equity as home values have sharply declined in recent years,[26] and in part due to individual borrowers' inability to keep up with monthly payments as interest rates adjust upward.[27] Together, those forces have caused 12.9% of subprime loans issued in 2000 to end in foreclosure by May 2005.[28] As of March 2008, approximately 6,000,000 people had subprime loans on their homes.[29] Of these

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21 *See id.* at 615–17.

22 *Id.* at 615.

23 *Id.*

24 *See id.* at 612.

25 *See* Harney, *supra* note 19. One mortgage broker, for example, thought it was OK to claim an income as high as necessary for borrowers in order to qualify for a loan. *Id.*

26 Press Release, Standard & Poor's, Continued Record Home Price Declines According to the S&P/Case-Shiller Home Price Indices (Sept. 30, 2008). The 10-City and 20-City Composite Home Price Indices declined 21.1% and 19.5% respectively between July 2006 and July 2008. *Id.* Las Vegas posted a 29.9% one-year decline, while Phoenix, Miami, Los Angeles, San Francisco, Minneapolis, and Portland, Oregon, posted 29.3%, 28.2%, 26.2%, 24.8%, 13.1%, and 6.6% declines respectively. *Id.*

27 Herman, *supra* note 14.

28 SCHLOEMER ET AL., *supra* note 3, at 11.

29 Edmund L. Andrews, *Relief for Homeowners is Given to a Relative Few*, N.Y. TIMES, Mar. 4, 2008, at C7.

6,000,000, about 408,000, or 6.8%, were in foreclosure.[30] An additional 1,002,000, or 16.7%, were behind in their payments.[31] Furthermore, it is projected that 19.4% of the subprime loans issued during the peak years of 2005 and 2006 will end in foreclosure, costing homeowners $74.6 billion, primarily in lost equity.[32]

The effect of such widespread foreclosures extends well beyond the individual borrower. The Center for Responsible Lending predicted that foreclosures on subprime loans originating in 2005 and 2006 will devalue 40.6 million neighboring homes by approximately $202 billion.[33] As a result, twenty-four states could lose more than $1 billion each from their respective tax bases,[34] decreasing each state's revenues and their ability to fund schools, police departments, and other public services.

II
SECURITIZATION OF THE SUBPRIME LOAN MARKET

The complex securitization[35] of the subprime loan market and its lax standards are partly to blame for the current crisis. In order to effectively regulate subprime loans, it is important to understand how the subprime loan market works and the problems that securitization creates.

Current regulations—and the lack thereof—have created a system that not only allows lenders to create loan products that

30 *Id.*

31 *Id.*

32 SCHLOEMER ET AL., *supra* note 3, at 15–16. Subprime lending reached its peak in 2005 and 2006, just as the housing boom began to bust, causing depreciation in home prices and interest rates to spike.

33 CTR. FOR RESPONSIBLE LENDING, SUBPRIME SPILLOVER: FORECLOSURES COST NEIGHBORS $202 BILLION; 40.6 MILLION HOMES LOSE $5,000 ON AVERAGE 1 (2008), http://www.responsiblelending.org/pdfs/subprime-spillover.pdf.

34 *Id.* at 2.

35 Securitization is the complex process of transforming a non-liquid asset or group of assets (such as home mortgages) into a single security. That bundled security has greater liquidity than the assets individually, so it can easily be bought and sold among investors. Securitization also was thought to spread the risk of a single mortgage default from a single bank to numerous investors. Wall Street believed that a real estate mortgage's risk of default could accurately be predicted through statistical analysis. *See* Jonathan Cary, *Acquisition Financing: The Current Landscape Causes and Consequences of the US Credit Crunch*, 1695 P.L.I./Corp. 513, 518–20 (2008).

put borrowers at a high risk of foreclosure, but also gives lenders financial incentives to do so. Moreover, securitization has made it difficult for borrowers to hold lenders and related parties legally responsible for having taken advantage of them. Thus, in order to provide an adequate set of laws to protect borrowers, regulations must address not only the issuance of subprime loans, but the process of securitization as well.

Traditionally, loans involved only two or three parties per transaction: a lender, a borrower, and perhaps a guarantor.[36] In modern times, through securitization, a subprime loan transaction can involve up to twelve parties.[37] Today's loans, in particular subprime loans, are securitized by combining many loans secured by real estate collateral into a mortgage pool and selling securitized interests in the mortgage pool to investors.[38] Due to this significant change in loan transactions, many current regulations are no longer effective. In order to provide adequate regulations, regulators need to understand and address this change.

A. The Securitization Process

A loan transaction today is a complex and elaborate process, and securitization makes it only more so. The process begins when a borrower works with a mortgage broker to gain approval for a loan.[39] The broker will originate the loan in either his or her own name[40] or the name of the lender, and will almost immediately transfer the loan to the lender.[41] The lender then sells the loan to a different entity, which will package the loan

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36 Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2256 (2007). Loans traditionally only involved a borrower, a lender, and perhaps a federally sponsored institution that would either purchase the loan from the lender or guarantee the mortgage. *Id.*

37 *Id.* A typical transaction could involve a borrower, a broker, an originator of the loan, a seller, an underwriter, a trust, a trustee, multiple servicers, a document custodian, an external credit enhancer, a securities placement agent, and investors. *Id.*

38 Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 535–36 (2002).

39 *Id.* at 538.

40 This is done by using funding from a prearranged buyer of the loan, access to a warehouse of credit, or through the use of his own money. *Id.*

41 *Id.* at 538.

together with several other loans into a mortgage pool.[42] The entity will assign the loans to a limited liability entity, known as the "seller."[43] The seller will transfer the loans to a Special Purpose Vehicle ("SPV"), the sole purpose of which is to hold on to the mortgage pool and issue a security to the seller.[44] The transfer to the SPV is completed in order to reduce the potential liability on the seller from the loans and to increase the capital liquidity of the loans.[45] Because most SPVs are trusts, the trustee legally in charge will be responsible for handling the operations of the SPV.[46]

The seller will then package the securities in a way that maximizes their appeal to potential purchasers,[47] such as by packaging the mortgages into geographically diverse pools.[48] The packages are usually rated by an independent credit-rating agency so investors can determine the value of the security and the return on investment demanded for the amount of risk associated with each security.[49] The credit rating systems attempt to use a numerical system to quantify the relative likelihood that the loans will be repaid by the borrowers in the mortgage pool.[50] Low-rated securities can be improved by a credit enhancement that reduces the risk to an investor.[51] This can be done by an internal credit enhancement, such as adding additional assets to the security to further spread the risk and increase value, or through an external credit enhancement by a

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42 *Id.*

43 *Id.* at 539.

44 *Id.* SPVs are equivalent to Special Purpose Entities ("SPE"), BLACK'S LAW DICTIONARY 1433 (8th ed. 2004), which Enron made famous.

45 Eggert, *supra* note 37, at 542. The SPV is usually a trust because it is considered the best entity form to preserve bankruptcy remoteness. *Id.* at 542–43. Its assets are secure even if the parent or guarantor is subject to bankruptcy proceedings. *See id.* at 539 n.157. However, the SPV can also be a corporation, limited partnership, or other business entity. *Id.* at 539. Whatever the form of organization, the main purpose of SPVs is to separate these risky loans from other assets and to isolate the risks associated with the original lender or pooler of the loans. *Id.* at 542–43.

46 *Id.* at 544.

47 *Id.* at 539.

48 Peterson, *supra* note 36, at 2186–87.

49 Eggert, *supra* note 38, at 540.

50 K.C. McDaniel, *Impact of Securitization and Conduit Financing*, SM002 A.L.I.-A.B.A. 1149, 1151 (2006).

51 Eggert, *supra* note 38, at 540–41.

third party, such as adding mortgage insurance to each loan in the security.[52] Mortgage insurance will insure up to a certain percentage of the value of each loan so that an investor's risk of loss will be minimized if the borrower defaults or the loan is repaid early.[53] In addition, an underwriter will work with the seller to package the loan pool[54] to ensure that the risk is appropriately spread among the assets in the security, and that one loan does not impose too much risk to the package as a whole.[55] The underwriter helps the rating agency examine the loans in the pool and set the standard risk-of-loss probability for the pool.[56] Any loans not meeting that standard are removed from the pool and returned to the originator.[57]

Once the security is rated, it is sold to investors through private placements or public offerings.[58] Finally, because the SPV and investors do not collect payments from borrowers, the SPV through its trustee hires a servicer, a company which specializes in collecting and distributing the income and principal from the loan pools, to handle the collection efforts, including foreclosure proceedings if needed.[59]

Similarly, investors sell and assign notes among themselves frequently through the Mortgage Electronic Registration System, Inc. ("MERS").[60] MERS is a document custodian that handles more than half of the home mortgage notes in the United States.[61] MERS maintains a national database that electronically keeps track of the owner and servicer on each mortgage in its system.[62] MERS records each loan with the county under its own name once, and then uses its electronic system to facilitate the trading of the mortgage notes without the

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52 *Id.* at 541.

53 *Id.*

54 *Id.*

55 McDaniel, *supra* note 50, at 1151.

56 Eggert, *supra* note 38, at 541.

57 *Id.*

58 *Id.* at 542. Common investors include private individuals and institutional investors such as mutual funds, pension funds, and insurance companies. *Id.*

59 *Id.* at 543–44.

60 *See* Peterson, *supra* note 36, at 2211.

61 *Id.*

62 *Id.*

assignee having to re-record the loan each time they are sold.[63] Additionally, MERS brings foreclosure proceedings in its own name—although it is not legally the holder of the note—while having the servicer seize the home if the proceeding results in foreclosure.[64]

B. Problems Arising Out of the Securitization Process

The securitization process is complex and has proven problematic in many respects. Understanding these problems is important in order to recognize why current regulations fail to effectively regulate the subprime market.

Among the problems the process of securitization has created is the fact that no party involved in the securitization process has a financial incentive to look beyond its own interests. Most importantly, there is no incentive to look after borrowers. For instance, mortgage brokers may steer borrowers toward lenders that provide better compensation packages for the broker, often resulting in greater cost to the borrower.[65] Further, brokers inflate loans to receive kickbacks from loan fees charged to a borrower.[66] Brokers also are compensated through yield spread premiums, which they receive for charging a borrower an interest rate above the rate required by the lender.[67] Similarly, brokers have incentives to push borderline borrowers into subprime loans rather than prime loans because they receive greater compensation due to kickbacks from the higher interest rates charged on subprime loans.[68] Moreover, originators quickly turn around and resell the loans without concern for the

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63 *Id.* at 2265–66.

64 *Id.* at 2266.

65 Kathleen E. Keest, *Stone Soup: Exploring the Boundaries Between Subprime Lending and Predatory Lending*, 1241 P.L.I./Corp. 1107, 1135 (2001).

66 *Id.* "Inflating" a loan is used here to refer to the practice of encouraging a borrower to take out a greater loan than that borrower might otherwise receive or ask for.

67 Lloyd T. Wilson, Jr., *Effecting Responsibility in the Mortgage Broker-Borrower Relationship: A Role for Agency Principles in Predatory Lending Regulation*, 73 U. CIN. L. REV. 1471, 1514 (2005). Yield spread premiums are the difference between the interest rate the lender requires and the interest rate actually sold to a borrower. *Id.* Lenders give brokers a rebate based on this difference. *Id.* Thus, brokers often have a financial incentive to charge even higher interest rates than demanded by the lender.

68 *See* Eggert, *supra* note 38, at 553–54.

quality of the loan.[69] Intermediaries (whose job is to combine the loans into a mortgage pool) are reluctant to exercise any significant diligence because of the size and narrow profit margins of the transaction.[70] Under most pooling agreements, the intermediaries have a right to force originators to take back any loan not properly qualified for the pool; as a result, they are less concerned with the quality of the loans.[71]

Second, the securitization of subprime loans—and of mortgages in general—has made it difficult for borrowers to assert legal claims or defenses in proceedings by or against the borrower. For example, the holder in due course doctrine, which prevents assignee liability[72] and shields investors who either buy or are assigned a loan, protects investors from the claims and defenses a borrower might assert. This protection from liability is particularly significant in light of the growing practice of "loan flipping"—unnecessary, predatory refinancing—by short-term lending entities that may quickly disappear, leaving borrowers with no party against whom to assert claims or defenses.[73] Additionally, now that brokers and lenders turn around and sell the loans almost immediately, they are able to issue loans in amounts exceeding the value of their assets to cover any potential claims brought by borrowers.[74] Thus, it is increasingly difficult for borrowers to assert claims and defenses against brokers, lenders, and investors when foreclosure proceedings occur.

Third, with loans changing hands so frequently, it has become difficult to figure out who actually owns a particular mortgage. In several cases, that difficulty has resulted in the wrong party foreclosing on the note,[75] due in part to the absence of any

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69 Peterson, *supra* note 36, at 2271.

70 McDaniel, *supra* note 50, at 1151.

71 *Id*. By being able to force loans back onto originators, intermediaries are shielded by the originator's representations and breaches of those representations if any problems arise. *Id.* This further demonstrates how parties involved in the securitization process have little incentive to be concerned for the quality of the mortgage as they will not be liable if there is a problem with a loan.

72 Assignee liability allows an individual to assert legal claims against the assignee of a loan.

73 Peterson, *supra* note 36, at 2270–73.

74 Eggert, *supra* note 38, at 548.

75 *See, e.g.*, *In re* Foreclosure Cases, 2007 WL 3232430 (N.D. Ohio, Oct. 31, 2007); Deutsche Bank Nat'l Trust Co. v. Steele, 2008 WL 111227 (S.D. Ohio, Jan. 8, 2008);

requirement that foreclosing parties show proof of ownership prior to foreclosure.[76] For example, MERS has been able to foreclose on loans without providing the original note.[77] Borrowers lose valuable information and evidence that could give rise to claims or defense when MERS is not required to produce the original loan.[78]

Altogether, securitization has created a system that gives lenders and brokers financial incentives to push expensive loans with unfavorable terms for borrowers that ultimately increase the loan's level of risk. Additionally, the securitization of subprime loans make it *de facto* impossible to hold brokers, lenders, note holders, and investors accountable if they take advantage of a borrower. As long as there is no duty on the lenders' part to look out for the borrower, and so long as investors continue to heavily invest in loan securities, subprime loans will be a risky product for borrowers. Therefore, the problems that securitization has caused must be addressed before effective regulation can take place to alleviate the subprime crisis.

III
FEDERAL REGULATIONS

The federal government, through Congress and federal agencies, has taken several approaches to try to regulate and provide protection from the subprime mortgage market. Unfortunately, the resulting patchwork of regulations[79] does not solve the problems of the subprime mortgage market effectively. The laws and regulations currently in effect include the Real Estate Settlement Procedures Act of 1974,[80] the Truth in

see also Gretchen Morgenson, *Fighting for a Home: Bundled Mortgages and Dubious Fees Complicate Foreclosure Cases*, N.Y. TIMES, Mar. 4, 2008, at C1.

76 Morgenson, *supra* note 75 (noting University of Iowa Professor Katherine M. Porter's study that found forty percent of foreclosures in 2006 did not require proof of ownership).

77 Peterson, *supra* note 36, at 2266–67.

78 *Id.*

79 I use the term "regulations" to refer both to laws enacted by Congress and regulations passed by the various agencies that oversee banking and lending practices in the United States.

80 12 U.S.C. § 2601(a) (2000).

Lending Act,[81] the Home Ownership and Equity Protection Act of 1994,[82] and, most recently, a "Statement on Subprime Mortgage Lending" issued jointly by several federal monetary agencies.

While those regulations do focus on typical subprime provisions, they apply only to the relatively small number of loans that include interest rates or fees high enough to trigger the laws' effect. As a result, lenders can often avoid such regulations altogether by structuring the rates or fees in such a way that avoids the "trigger" provision. Moreover, in cases where the regulations do apply, lenders and brokers can often provide the borrowers with the required disclosures without actually ensuring the borrower fully understands the provisions of the loan. Finally, none of the regulations addresses the problem of allowing note holders and MERS to file for foreclosure without the proper documentation.

A. The Real Estate Settlement Procedures Act

Congress enacted the Real Estate Settlement Procedures Act ("RESPA") to ensure borrowers receive better information in a timelier manner on the costs charged in the mortgage settlement process.[83] Congress hoped that the requirements of RESPA would result in more well-informed borrowers.[84] Having more well-informed borrowers would, by encouraging borrowers to compare various loan terms, eliminate the kickback and referral fees that increase loan costs.[85] In addition, more well-informed borrowers would help drive down the amount borrowers are required to place in escrow to ensure the properties' taxes and insurances would be paid.[86]

To achieve those objectives, RESPA requires that lenders or mortgage brokers distribute booklets explaining the nature and costs of real estate settlement services within three business days of receiving or preparing an application for a borrower.[87]

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[81] 15 U.S.C. § 1601(a) (2000).

[82] 15 U.S.C. § 1639 (1994).

[83] 12 U.S.C. § 2601(a) (2000).

[84] *Id.* § 2601(b)(1).

[85] *Id.* § 2601(b)(2).

[86] *Id.* § 2601(b)(3).

[87] *Id.* § 2604(a)–(d).

Additionally, either the lender or mortgage broker is required to give each borrower a good-faith estimate of the charges the borrower is likely to incur in connection with the settlement within three business days after the loan application is received or prepared.[88] RESPA also requires the development and use of a standard real estate settlement form that clearly and conspicuously itemizes all of the costs of settlement.[89] This form must be completed and made available to the borrower at or before the settlement, and the borrower is given the right to demand to review the form the day prior to the settlement signing.[90]

RESPA, however, is inadequate. Even assuming borrowers take the time to sit down and read the handbook, there is no guarantee they will understand the information they are given.[91] Providing extremely complicated information, particularly to unsophisticated borrowers, does not ensure they will understand it. Regulations also need to ensure borrowers understand that information.

B. The Truth in Lending Act

Congress enacted the Truth in Lending Act ("TILA") in 1968 to ensure borrowers understand the true cost of a loan, enabling borrowers to compare loans and thereby enhancing competition among lenders.[92] To that end, TILA requires lenders to disclose all finance charges in terms of an Annual Percentage Rate

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88 24 C.F.R. § 3500.7(a) (2008); 12 U.S.C. § 2604(c) (2000).

89 12 U.S.C. § 2603(a) (2000).

90 *Id.* § 260 3(b).

91 *See* Andrews v. Chevy Chase Bank, FSB, 240 F.R.D. 612, 615 (E.D. Wis. 2007).

92 15 U.S.C. § 1601(a) (2000). The House Report on TILA demonstrates Congress's desire that borrowers know the true cost of their loans, stating:

> If consumers are to plan prudently and to shop wisely for credit, they must know what it really costs. In many instances today, consumers do not know the cost of credit. Charges are often stated in confusing or misleading terms. They are complicated by 'add-ons' and discounts and unfamiliar gimmicks. The consumer should not have to be an actuary or a mathematician to understand the rate of interest that is being charged. As a matter of fair play to the consumer, the cost of credit should be disclosed fully, simply, and clearly.

H.R. REP. NO. 90-1040, at 9 (1967), *reprinted in* 1968 U.S.C.C.A.N. 1962, 1965.

("APR").[93] TILA also requires the clear and conspicuous disclosure[94] of the creditor's identity,[95] the amount financed,[96] information regarding any variable interest rate,[97] the payment schedule,[98] and the total amount that will ultimately be paid by the borrower.[99] TILA requires additional disclosures for high-interest loans.[100] Similar to RESPA, TILA requires that all disclosures be clear, conspicuous, in writing, and given to the borrower at least three days before the closing of the loan.[101]

Additionally, TILA (as amended by the Home Ownership and Equity Protection Act) prohibits high-interest loans from including certain terms.[102] The prohibited terms include balloon payments (unless the loan matures in less than one year), negative amortization, interest rate increases upon default,[103] and prepayment penalties after five years from the date the loan

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93 Truth in Lending, 12 C.F.R. § 226.18(e) (2008). Title 12, Section 226 of the Code of Federal Regulations, known as "Regulation Z," defines finance charges as "any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit." 12 C.F.R. § 226.4(a). Examples of these additional charges calculated as the APR of a loan include loan fees, fees for a credit report, borrower-paid mortgage broker fees, and insurance protecting the creditor against the borrower's default. 15 U.S.C. § 1605(a)(1)–(6). However, any charges imposed by a third-party closing agent are not required to be included in the finance charge. *Id.* § 1605(a).

94 12 C.F.R. § 226.17(a).

95 *Id.* § 226.18(a).

96 *Id.* § 226.18(b).

97 *Id.* § 226.18(f). If the loan on the borrower's principal dwelling has a term of one year or less, the lender must disclose the circumstances under which the rate may increase, any limitation on the increase, the effect of an increase, and an example of the payment terms that would result from an increase. *Id.* § 226.18(f)(1). If the term of a variable rate mortgage is more than a year, the disclosure need only state that the loan contains a variable interest rate and that variable rate disclosures have been provided earlier. *Id.* § 226.18(f)(2).

98 *Id.* § 226.18(g).

99 *Id.* § 226.18(h) (the disclosure must contain a statement such as "the amount you will have paid when you have made all scheduled payments").

100 12 C.F.R. § 226.31(c). High-interest loans are defined in Regulation Z as loans containing an APR exceeding the yield on treasury securities of comparable periods of maturity by more than eight percentage points for first-lien loans and ten percentage points for subordinate-lien loans, or those in which the total points and fees exceed the greater of eight percent of the total loan amount or $400. *Id.* § 226.32(a).

101 *Id.* § 226.31.

102 *Id.* § 226.32(d).

103 *Id.*

was consummated.[104] Furthermore, lenders are barred from refinancing a loan subject to TILA into another loan also subject to TILA, unless it is in the borrower's best interest.[105] A final key restriction under TILA prohibits high-interest loans that are based solely on the borrower's collateral without concern for the borrower's actual ability to repay the loan.[106]

While TILA contains stricter disclosure rules than RESPA, those disclosure rules apply only to particularly high-interest loans. Therefore, TILA's stricter disclosure rules can be avoided if a loan charges rates and fees just below the trigger rate[107] while maintaining otherwise unfavorable terms. Unsurprisingly, lenders have been willing to do so,[108] taking in more money in the long run by evading TILA's stricter disclosure rules and encouraging a borrower to refinance a year later—charging the borrower yet another round of fees. Additionally, TILA does not define what is in a borrower's interest and thus allows lenders another loophole in refinancing a subprime loan.

C. Home Ownership and Equity Protection Act

Similar to TILA, the Home Ownership and Equity Protection Act ("HOEPA") prohibits high-interest loans from containing balloon payments, prepayment penalties, and negative amortization provisions.[109] HOEPA also requires that several specific disclosures be given to borrowers at least three days before the closing of the loan, including the APR and the amount of the regular monthly payment.[110] If the loan has a variable interest rate, the lender must also provide to the borrower a statement that the interest rate and monthly payment could increase, and state the maximum monthly payment that could result if the loan reached its maximum interest rate.[111]

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[104] 15 U.S.C. § 1639; 12 C.F.R. § 226.32(d).

[105] 12 C.F.R. § 226.34(a)(3).

[106] 12 C.F.R. § 226.34(a)(4).

[107] Michael J. Pyle, *A "Flip" Look at Predatory Lending: Will the Fed's Revised Regulation Z End Abusive Refinancing Practices?*, 112 YALE L.J. 1919, 1923 (2003); Eggert, *supra* note 38, at 588.

[108] Pyle, *supra* note 107, at 1923.

[109] 15 U.S.C. § 1639(c)–(h).

[110] *Id.* § 1639(a)–(b).

[111] *Id.* § 1639(a)(2)(B).

However, HOEPA is ineffective because lenders can avoid its requirements in much the same way that lenders can avoid TILA requirements. HOEPA is only triggered if a loan's APR exceeds the yield on treasury securities of comparable periods of maturity by more than eight percentage points for first-lien loans and ten percentage points for subordinate-lien loans.[112] HOEPA's regulations will also be triggered if the total points and fees the borrower has to pay exceed the greater of eight percent of the total loan amount or $400.[113] As a result, HOEPA suffers from the same flaw as does TILA: loans with interest rates and fees set just below the trigger rate can still include the risky and confusing subprime loan provisions that have helped create the current crisis.

While assignee liability is provided for under HOEPA,[114] for that provision to have any effect the loan has to trigger HOEPA first. This provides another incentive for lenders to charge rates and fees just below the trigger rate, because an investor is more likely to purchase a loan not subject to HOEPA's assignment rule than one that is, in order to remain protected from liability.

Even if a borrower brings a legal claim that his loan violated HOEPA, the borrower must clear significant hurdles in order to prevail. For example, if the loan has been assigned, the borrower first has the difficult task of demonstrating that an assignee could tell from the face of the disclosure statement that it was inaccurate.[115] Second, the borrower's claim will not succeed if the assignee or purchaser proves by a preponderance of the evidence that, in exercising ordinary due diligence, a reasonable person would have been unable to determine HOEPA applied to the loan.[116] Altogether, the burdens on the borrower are particularly high—meaning that even if assignee liability is present under HOEPA in theory, it may not be of any practical effect. Thus, HOEPA may be unlikely to create assignee liability and ensure borrowers become informed.

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112 *See id.* § 1602(aa); 12 C.F.R. § 226.32(a).

113 *See* 15 U.S.C. § 1602(aa); 12 C.F.R. § 226.32(a).

114 15 U.S.C. § 1641(d)(1).

115 *Id.* § 1641(a).

116 *Id.* § 1641(d)(1).

D. Agencies' Statement on Subprime Mortgage Lending

On June 29, 2007, several federal monetary agencies—namely, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (the "Agencies")—issued a "Statement on Subprime Mortgage Lending" to address concerns over lending practices in the subprime mortgage market.[117] The Agencies' statement, concerned primarily with option ARMs and teaser rates, provides guidance on the proper disclosures to be given to borrowers and underwriting practices for financial institutions that are overseen by the Agencies.[118] The Agencies stated that financial institutions should explain introductory rates, prepayment penalties, balloon payments, the risks of "liar loans," and whether the loan will include additional costs associated with taxes and insurance for the property in question.[119] Requiring such explanations, the statement explains, is intended to ensure the borrower understands all the risks associated with the loan.[120] The statement also recommends that lenders, when underwriting a loan, use a debt-to-income analysis to approve loans based on a borrower's ability to repay the loan.[121] This includes the borrower's ability to pay the higher interest rate after the introductory APR expires.[122]

Even though the Agencies' statement appears to give lenders an affirmative duty to ensure borrowers are well informed and understand the loan's terms, the statement only applies to financial institutions that lend money from their depositors.[123]

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117 Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37,569, 37,569 (July 10, 2007) [hereinafter Agencies' Statement].

118 *Id.* at 37,569.

119 *Id.* at 37,573–74.

120 *Id.*

121 *Id.* at 37,574.

122 *Id.*

123 *See* Joseph A. Smith, Jr., *The Federal Banking Agencies' Guidance on Subprime Lending: Regulation with a Divided Mind*, 6 N.C. BANKING INST. 73, 74–75 (2002) (stating that the Agencies regulate banking organizations including banks, thrift institutions, and their holding companies); *Regulators Tighten Standards for*

As most brokers and lenders are not actual banks with depositors,[124] the statement will be an ineffective regulation in the subprime mortgage industry for three reasons. First, the Agencies' limited reach—in particular, the limits of their statement of guidance—demonstrates that the Agencies should not be depended on to protect borrowers.[125] Second, the Agencies' primary concern is to ensure the soundness of the banking and monetary system, not to protect consumers.[126] Finally, as with many lending regulations, merely giving borrowers disclosures does not ensure borrowers will actually understand them.

IV
STATE REGULATIONS

Since federal regulations are inadequate to protect borrowers, the next logical question is whether state regulations are sufficient to protect borrowers where federal laws are not. Here, I examine the laws of four states—Oregon, California, Florida, and Minnesota—to illustrate the variety of state regulations currently in place.

Altogether, many of the regulations of California and Florida—two states particularly heavily hit by the subprime crisis—are nearly carbon copies of their federal counterparts. As a result, those state regulations are inadequate for largely the same reasons. Minnesota's regulations, also similar to the federal regulations, are flawed because the regulations can easily be avoided. However, Minnesota contains a distinct provision that places an agency duty on brokers. Oregon has come close to enacting many necessary regulations, but they have generally not made it past that state's legislature. Importantly, none of these states address assignee liability or require note holders to produce the original loan documents prior to foreclosure.

Subprime Mortgages, USA TODAY, June 29, 2007, http://www.usatoday.com/money/economy/housing/2007-06-29-subprime-standards_N.htm.

124 *See Regulators Tighten Standards*, *supra* note 119 (reporting that the majority of lenders are independent businesses that loan money received through the securities market).

125 Pyle, *supra* note 107, at 1926.

126 *See* Federal Reserve Act § 2a, 12 U.S.C. § 225a (2000); Pyle, *supra* note 107, at 1926.

Overall, none of these states have subprime loan regulations in place that adequately protect borrowers.

A. Oregon Regulations

Although several Oregon laws regulate predatory lending practices in the realm of payday and title loans,[127] Oregon currently has no law that specifically addresses subprime lending. Oregon law currently does not limit the interest rate a financial institution can charge in issuing a loan[128] as long as the "terms and conditions . . . are consistent with safe and sound banking practices."[129] However, "safe and sound banking practices" is not defined. If one considers "safe and sound banking practices" to include the current federal banking practices that have allowed for the current crisis to arise, such a law is ineffective. The law is also inadequate if it is "safe and sound" for lenders to have high finance charges. For instance, Oregon law allows a licensee to include finance charges that, when expressed as an APR, do not exceed the greater of thirty-six percent or thirty percentage points above the ninety-day discount rate for commercial paper charged by the Federal Reserve Bank of San Francisco.[130] Thus, because Oregon law prohibits only those loans that charge an interest rate above thirty percent—a regulation aimed squarely at short-term predatory "payday loans"—Oregon law fails to address subprime lending problems entirely. Oregon law also fails to address assignee liability or production of original loan documents prior to foreclosure, and does not impose a duty on brokers to act in a borrower's best interest.

Not only does Oregon currently fail to regulate subprime loans, but the ideas that the Oregon legislature has put forth to address the subprime loan crisis, such as the proposed Oregon Home Loan Fairness Act, are also inadequate.[131]

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127 H.B. 2871, 74th Legis. Assemb. (2007) (focusing on payday loans and amending OR. REV. STAT. §§ 725.010, 725.045, 725.340, and others).

128 OR. REV. STAT. § 708A.255 (2007).

129 OR. REV. STAT. § 708A.250 (2007).

130 *See* OR. REV. STAT. § 725.340 (2007), amended by H.B. 2871.

131 S.B. 965, 74th Legis. Assemb. (2007). Although S.B. 965 never became law, the bill is important to examine as it shows how the State of Oregon thinks the subprime problem might be solved.

Oregon Senate Bill 965, also known as the Home Loan Fairness Act, was introduced during the 2007 Oregon legislative session. Although the Home Loan Fairness Act did contain a few well-thought-out provisions, it ultimately failed to become law.[132] Oregon Senate Bill 965 attempted to address subprime lending practices in Oregon by making several improvements on existing federal regulations.

Unlike HOEPA and TILA, Oregon Senate Bill 965 would have applied to all subprime loans regardless of the interest rate charged by the loan.[133] Additionally, in contrast to the Agencies' statement, the bill would have broadly applied to all lenders, including mortgage brokers,[134] banks,[135] credit unions, or licensees.[136] The bill also would have required lenders of "nontraditional mortgages" to analyze a borrower's repayment ability at the fully indexed rate[137] rather than using the borrower's credit score as an alternative to verifying a borrower's income.[138] Doing so would make sure borrowers are able to meet their payment obligations after the teaser rate ends and would reduce the number of borrowers in foreclosure. However, lenders would not be barred from issuing "liar loans"—those made without documentation of income or assets—as long as there were adequate reasons to support such a loan's use, such as high credit scores, low debt-to-income ratio, significant liquid assets, mortgage insurance, and other factors.[139]

Additionally, Oregon Senate Bill 965 followed the lead of laws in other states by prohibiting lenders from relying on the sale price or refinancing value of the property instead of the borrower's ability to repay the loan when approving the loan.[140]

132 *Id.* That S.B. 965 failed to pass is surprising because subprime loans are similar to payday loans, which Oregon regulates heavily. It seems reasonable that Oregon would also protect individuals from high-cost home loans.

133 *Id.*

134 *See* OR. REV. STAT. § 59.840(5) (2007) (defining the term "mortgage banker" as anyone who is compensated or expects to be compensated for making or negotiating a mortgage loan and either "[s]ervices or sells a mortgage banking loan").

135 *Id.* § 706.008(1).

136 S.B. 965, 74th Or. Legis. Assemb. § 2(4) (2007).

137 *Id.* § 5(3).

138 *Id.* § 4.

139 *Id.* § 5(1).

140 *See id.* § 4(2)–(4).

The bill would also have forbidden no-money-down and negative amortization subprime loans unless the loans were issued under the significant mitigating factors used above.[141] Along with requiring certain disclosures by lenders,[142] the bill would also have imposed a duty on lenders using a mortgage broker to ensure that the broker complies with the regulations.[143] The bill further stated that an appropriate step for lenders would be to create compensation incentives for brokers to issue loans consistent with the bill's provisions.[144]

Unlike its federal counterparts, Oregon Senate Bill 965 would have regulated lenders and the loans they could issue *regardless* of the interest rate. However, the bill was problematic for several reasons. First, rather than imposing a duty specifically on the broker, the bill imposed a duty on the lender to ensure brokers comply with the lender's duties.[145] The bill thus provided a remedy for borrowers against lenders but failed to provide a specific remedy for borrowers against brokers. Since it is brokers who deal directly with borrowers, borrowers should be able to assert their rights in a cause of action against brokers as well as against lenders.

Second, Oregon Senate Bill 965 failed to address the fact that many brokers and lenders either have inadequate assets to cover claims or disappear from the market after making a large number of loans.[146] This is a problem because the holder in due course doctrine protects investors who own the mortgage note.[147] This leaves borrowers with no effective remedy because brokers and lenders are either insolvent or absent while the note holders are protected by law. Finally, there was no attempt in Oregon Senate Bill 965 to force MERS or other note holders to file the original loan documents prior to foreclosure.

While Oregon Senate Bill 965 had several promising provisions, it also had several shortcomings. Further, the provisions never actually became law. As a result, Oregon is left

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141 *Id.* § 5(3).

142 *Id.* § 8–9.

143 *Id.* § 7(3).

144 *Id.* § 7(3)(b).

145 *See id.* § 7.

146 *See id.*

147 OR. REV. STAT. § 73.0302 (2007). Oregon's holder in due course doctrine, codified in ORS 73.0302, is identical to the one codified in U.C.C. § 3-302.

without adequate regulations to protect borrowers from predatory subprime loan practices.

B. California

Similar to the federal subprime loan regulations, California's statutes appear more extensive than they are. To begin with, California's statutes prohibit and regulate several specific subprime loan provisions and practices. Those provisions and practices include prepayment penalties, negative amortization, interest rate increases upon default, and loan flipping (unnecessarily refinancing one subprime loan into another subprime loan).[148]

However, similar to HOEPA, these protections are only triggered by high-cost loans and can be avoided with a little planning on the part of the lender. Under California law, the trigger rate for a first-lien loan is an interest rate of eight percentage points above the yield on treasury securities having comparable periods of maturity, or the total points and fees charged to the borrower exceeds six percent of the total loan amount.[149] A loan charging interest rates slightly below those trigger rates—though it may contain several subprime provisions that would otherwise be prohibited—is not subject to those protections under the California law.

Even if a loan does trigger the California statute, the statute contains loopholes that allow lenders to evade the regulations and still include subprime provisions in a high-cost loan. For instance, although negative amortization is one of the provisions regulated, California law *allows* negative amortization if the originator simply discloses to the borrower that the loan provides for negative amortization and that such a provision may increase the loan principal.[150]

California law also requires that the issuance of a loan must be based upon a borrower's current and expected income, current

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148 CAL. FIN. CODE § 4973(a)–(c), (e), (j) (West Supp. 2008).

149 *Id.* § 4970(b).

150 *See id.* § 4973(c); *see also id.* § 4973(a)(2) (allowing prepayment penalties during the first thirty-six months of the loan if three conditions are met: the prepayment fee must not exceed the amount of six months' worth of interest payments, the originator must also offer the borrower another loan without a prepayment fee, and the originator must disclose in writing at least three days prior to signing the loan that it contains a prepayment penalty).

obligations, and employment status, rather than merely the borrower's equity. Furthermore, ARM loans must be based on the borrower's ability to repay at the fully indexed rate, not at the teaser rate.[151] However, as mentioned above, these regulations only apply to high-cost loans; many lenders will simply be able to avoid the regulations by charging an interest rate just below the statutory trigger rate.

Some might argue that California puts borrowers on notice to carefully inspect their loan documents because the California statute requires originators of a high-cost loan to provide the borrower a disclosure that recommends the borrower consult with a financial advisor prior to signing the loan.[152] However, that requirement will not adequately protect borrowers so long as brokers and lenders have significant financial incentives to pressure a borrower *not* to consult with a financial advisor or to slip the notification in with the mountain of loan paperwork.[153]

California law also provides protections for borrowers at the postlitigation level by explicitly allowing courts to award punitive damages to borrowers on top of actual damages and attorney fees.[154] However, this statutory provision will not effectively deter loan brokers or originators if, because lenders often issue numerous loans and quickly disappear from the market, the borrower cannot find a party against whom to assert a claim.

Moreover, California law does not require an original loan document to be submitted prior to foreclosure and explicitly *does* uphold the holder in due course doctrine for negating assignee liability.[155] As a result, California's regulations simply mirror many problems inherent in the federal regulations by upholding the holder in due course doctrine for mortgages,

[151] *Id.* § 4973(f)(1).

[152] *See id.* § 4973(k)(1).

[153] This is but one difficulty borrowers face when seeking remedies. Although a borrower might be able to assert a legal claim against the originator, the originator will often be either insolvent or missing. The borrower will then have to assert a claim against the assignee. However, the holder in due course doctrine will shield the assignee from any liability because he would not have been able to tell from the loan documents alone that the originator did not give the borrower the required notifications.

[154] CAL. FIN. CODE § 4978 (West Supp. 2008).

[155] *Id.* § 4979.8.

failing to require production of the loan documents, and creating a set of toothless "requirements."

C. Florida

Like California, Florida only regulates risky loan provisions in high-cost loans. However, because Florida's law expressly defers to the definitions and criteria set out by HOEPA,[156] lenders in Florida can easily avoid state regulations by charging an interest rate and fees just below the trigger rate. While Florida's statute is not as extensive, it does regulate several of the same provisions as California and the federal regulations. These regulated provisions include prepayment penalties, negative amortization, repayment ability, and refinancing.

Under Florida law, a subprime loan may not contain a prepayment penalty unless three criteria are satisfied: the prepayment must occur during the first thirty-six months of the life of the loan, the borrower must be offered another loan without a prepayment penalty, and the borrower must be given a disclosure of the terms—including the benefit the borrower will receive for accepting the prepayment penalty—at least three business days prior to closing.[157] The language of this provision is troublesome because it does *not* guarantee that a borrower will receive information *about the risks of prepayment penalties*, which can be substantial.

Florida law also prohibits subprime loans from containing provisions that will result in negative amortization[158] and requires lenders to consider the borrower's ability to repay the loan in addition to the borrower's collateral when extending credit.[159] Yet Florida law is silent in explaining how a lender should determine a borrower's ability to repay a loan that contains a teaser rate: may a lender base that determination on only the initial rate, or must the lender take into consideration the fully indexed rate over the life of the loan?

Finally, Florida does not allow a lender to refinance a high-cost home loan to the same borrower within eighteen months of

156 FLA. STAT. § 494.0079(7) (2007); *see also* 15 U.S.C. § 1602(aa) (2000); 12 C.F.R. § 226.32(a) (2008).

157 FLA. STAT. § 494.00791(1) (2007).

158 *Id.* § 494.00791(3)–(4).

159 *Id.* § 494.00791(6).

the original loan unless refinancing provides a "reasonable benefit to the borrower."[160] Therefore, a lender only has to wait until the nineteenth month to be free to refinance without regard to whether it might benefit the borrower. Florida also upholds the holder in due course doctrine as a defense for purchasers of mortgage notes,[161] providing a shield for investors who purchase the notes. Thus, Florida regulations present the same problems as the federal regulations discussed above.

D. Minnesota

In contrast to the laws of Oregon, California, and Florida, Minnesota law provides regulations that effectively protect a borrower where federal regulations do not. To begin with, Minnesota regulates the kinds of provisions that originators, servicers, and brokers may include in loans. For example, under Minnesota law, originators and servicers cannot lend a mortgage loan product that is of a comparatively lower investment grade to a borrower if, under the originator's underwriting standards, the borrower's data indicates he would qualify for a higher investment grade loan. In other words, a lender may not push a borrower who qualifies for a prime loan into a subprime loan.[162] However, an originator or servicer may offer a lower investment grade loan *after* informing the borrower he would qualify for a better loan and receiving the borrower's written consent.[163] However, as mentioned above, due to the mountain of paperwork involved in the purchase and financing of a home, a borrower's signature on such a disclosure may not actually represent the borrower's understanding that he or she may qualify for a loan of better quality.

160 *Id.* § 494.00791(9). A "reasonable benefit to the borrower" is not specifically defined. However, the statute does state that lenders should consider "all of the circumstances, including, but not limited to, the terms of both the new and refinanced loans, the cost of the new loan, and the borrower's circumstances." *Id.*

161 *Id.* §§ 673.2031, 673.3021, 673.3031 (validating the holder in due course doctrine as a defense as long as the note was transferred for value).

162 MINN. STAT. § 58.13 subdiv. 1(18) (2007). A higher investment grade loan is characterized as one having a lower interest rate and lower discount points. Conversely, a lower investment grade loan will have a higher interest rate and higher discount points.

163 *Id.*

Loan originators and servicers are also prohibited from issuing any loan with the "intent" that the loan will not be repaid so that the originator can obtain title to the property through foreclosure.[164] This is problematic because requiring proof of a lending institution's or an absent broker's intent is extremely difficult to prove, making the law that much more difficult to enforce.

Minnesota law also provides that originators and servicers are not allowed to assist a borrower to refinance into a new loan, unless it provides a "reasonable tangible net benefit" to the borrower.[165] Originators and servicers are also prohibited from offering loans that would result in negative amortization during any six-month period, except for reverse mortgage loans.[166] Minnesota has also eliminated "liar loans" by requiring originators and servicers to verify the borrower's ability to repay the loan, calculated at the fully indexed rate for variable interest rates.[167] Originators are also barred from including penalties, fees, or charges for prepayment in subprime loans, regardless of whether that prepayment is in full or in part.[168]

Minnesota uses a definition of "subprime loan" similar to that of the federal government, California, and Florida. However, Minnesota's definition uses a much lower interest rate. For first-lien variable rate loans, the rate of which does not decrease, a loan is classified as "subprime" if the interest rate exceeds two percentage points above treasury securities having comparable periods of maturity.[169] All other first-lien mortgages fall into the subprime category if they contain an APR greater than three percentage points above treasury securities of comparable periods.[170] For subordinate-lien loans, the APR has to exceed treasury securities of comparable maturity periods by five

164 *Id.* § 58.13 subdiv. 1(13).

165 *Id.* § 58.13 subdiv. 1(24).

166 *Id.* § 58.13 subdiv. 1(26).

167 *Id.* § 58.13 subdiv. 1(23).

168 *See id.* § 58.137 subdiv. 2(c). This is a very borrower-friendly provision. Conversely, many argue that prepayment penalties are necessary to ensure lenders receive their expected return on issued loans. However, barring prepayment penalties is not unfair because most residential mortgages also contain a "due upon sale" clause. This clause denies borrowers the use of the money loaned for the full term of the loan if they sell the home, which usually is the case.

169 *Id.* § 58.02.

170 *Id.*

percentage points.[171] Because Minnesota's "trigger" rates for subprime regulations are substantially lower than those of other states, Minnesota's regulations will apply to a far wider range of loans. Furthermore, such comparatively low "trigger" rates mean that for a lender to *avoid* statutory regulation, a loan would have to be set at a rate low enough to alleviate the effects of otherwise unfavorable loan terms.

Beyond regulating subprime provisions in a greater number of loans, Minnesota law also imposes a uniquely effective "agency relationship" upon mortgage brokers that requires them to act in the borrower's best interest with "the utmost good faith."[172] That agency relationship prohibits brokers from receiving, giving, or charging any undisclosed compensation without the borrower's knowledge.[173] To ensure compliance, brokers are required to account for all of the compensation as the borrower's agent.[174] Minnesota also imposes a duty on brokers to carry out all lawful instructions given by their clients.[175] Additionally, brokers are required to disclose *all* material facts to a borrower that may affect him.[176]

Minnesota's imposed agency relationship is a very progressive provision that will help ensure brokers look out for their clients, rather than merely seeking the terms that will be most advantageous to the lending parties. However, to fully protect borrowers, Minnesota will have to require production of the loan documents prior to foreclosure and limit investor demand for these risky loans. Altogether, Minnesota provides a good starting point but does not go far enough.

V
THE NEED FOR REGULATION

In order to prevent another subprime crisis, state and federal regulations need to protect unsophisticated borrowers, impose assignee liability, and require foreclosing parties to provide original documents. Current regulations are inadequate for

171 *Id.*
172 *Id.* § 58.161 subdiv. 1(1).
173 *Id.*
174 *Id.* § 58.161 subdiv. 1(5).
175 *Id.* § 58.161 subdiv. 1(2).
176 *Id.* § 58.161 subdiv. 1(3).

regulating subprime loans. The federal government must impose more stringent regulations to limit the impact of the current subprime crisis on the economy and to prevent another subprime crisis from occurring in the future. If proper regulations are not enacted, we risk repeating history as the financial climate again makes lenders willing to issue risky loans.[177]

It is also important to note that tougher regulations will not, as some critics fear,[178] cause lenders to stop issuing loans or cause the credit markets to shrink. HOEPA, for example, did not drive lenders out of the market as critics feared.[179] In fact, the number of subprime loans issued *increased* after the enactment of HOEPA.[180]

Even if regulations do "tighten up"[181] the credit available for subprime loans by limiting the number of loans lenders are willing to issue, such a change is unlikely to adversely affect those whom subprime loans are supposed to serve in the first place. Subprime loans serve the wholly legitimate purpose of helping financially capable individuals with tarnished credit purchase homes. Those individuals, unable to obtain a prime-rate loan but willing to make higher monthly payments to compensate for the risk their poor credit presents to a lender, justify the issuance of subprime loans. However, when lenders extend such loans to those without the financial means to meet their monthly obligations, the subprime market has overreached. If increased regulations "tighten up" the market, it will only serve to limit the issuance of subprime loans to those who should receive them.

While often the increased risk such borrowers present justifies the higher rates and fees subprime lenders charge, lenders often go further than necessary in several ways.[182] First, subprime

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177 *See infra* notes 199–202 and accompanying text (discussing the savings and loan crisis).

178 *See, e.g.*, Posting of Gary Becker to The Becker-Posner Blog, http://www.becker-posner-blog.com/archives/2007/06/are_subprime_lo.html (June 24, 2007, 23:35 EST).

179 Eggert, *supra* note 38, at 587.

180 *Id.*

181 "Tightening up" credit refers to when lenders become conservative and issue fewer loans, reducing the amount of money available for borrowers.

182 Keest, *supra* note 65, at 1133.

loans can include terms that are more unfavorable to borrowers than is necessary to compensate a lender's risk. Because the value of the home generally fully secures a mortgage, there is little need to further buttress a lender's risk with extensive fees and interest rates.[183] Second, lenders issue subprime loans *more often* than necessary: as many as thirty percent of those who could qualify for a prime loan are nevertheless steered by lenders into subprime loans.[184] Third, lenders structure many subprime loans in a way that creates additional risk of foreclosure instead of compensating for the naturally higher level of risk such borrowers present.[185] Thus, the government should regulate the market to ensure that lenders are seeking proper compensation for the increased risk, rather than taking advantage of, and creating additional risk for, unsophisticated borrowers.

Not only do lenders overreach, but lenders also structure many subprime loans so that the borrower does not truly own his home. Many borrowers do not put money down or make monthly payments that cover the monthly interest accrued. Moreover, falling home prices are destroying home equity. Current regulations (or the lack thereof) have created a market where approximately 8.8 million homeowners—more than ten percent of homeowners nationwide—have zero or negative equity in their homes.[186] This number could increase to 13.8 million—more than fifteen percent of the nation's households—if the market continues to worsen.[187]

The subprime loan market has not only failed to help families truly own a home; it has also decreased overall U.S. homeownership.[188] This decline results in part from the fact that

183 *Id.* I acknowledge that lenders may not recover 100% of their loan amount through foreclosure even though the loan is secured by the home. However, sophisticated business executives choose to create, and invest in, such risky loans. Placing the risk of loss on those sophisticated parties rather than the underinformed borrower is reasonable. Of course, the risk of loss should be shared equally—and probably placed on the borrower—if the borrower is also a sophisticated party such as a real estate speculator.

184 *Id.*

185 *Id.*

186 J.W. Elphinstone, *Home Equity Falls Below 50 Percent*, ASSOCIATED PRESS NEWSWIRE, Mar. 6, 2008, *available at* 2008 WL 4770814.

187 *Id.*

188 CTR. FOR RESPONSIBLE LENDING, *supra* note 4, at 2.

the majority of subprime loans are not issued to first-time home buyers but rather to individuals refinancing a current loan or to individuals moving and upgrading their current home.[189] In 2006, only an estimated eleven percent of all subprime loans issued were for first-time home buyers.[190] Stated in concrete terms, of more than three million subprime loans issued in 2006, only 354,172 brought new homeowners to the market.[191] In that same year, an estimated 624,631 subprime foreclosures took place—resulting in a net homeownership loss of more than 270,000 homes.[192]

Worsening matters further, there will likely be a continued increase in foreclosures in the near future. The number of subprime loan foreclosures has yet to reach its peak and is expected to increase until the fall of 2009.[193] Additionally, the poorest-quality loans were issued in the fall of 2006 and will not adjust until 2008 and 2009.[194] Given such immediate consequences, the federal government should not apply the "wait and see" approach. Instead, it should begin finding ways to minimize the devastating impact these loans will have on families and stop such circumstances from recurring in the future.

Critics argue against regulation for three reasons. First, many argue credit is like any other commodity and, as such, the market should be able to charge whatever people are willing to pay for the commodity.[195] Second, many critics claim that the wide publicity surrounding the subprime crisis has educated borrowers about the pitfalls of such loans. As a result, they argue, borrowers will already be more careful and will closely scrutinize their loans before signing on the dotted line.[196] Third,

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189 *Id.* at 3. In 2006, fifty-six percent of all subprime loans were refinancing loans. *Id.*

190 *Id.*

191 *Id.*

192 *Id.* at 4.

193 *See* Tom Fredrickson, *NYC Foreclosures Mount: Defaults Forecast Through 2008 as Rates Reset; Outer Boroughs Suffer*, CRAIN'S N.Y. BUS., July 30, 2007, at 1, 1–8.

194 *Id.*

195 Posting of Richard Posner to The Becker-Posner Blog, http://www.becker-posner-blog.com/archives/2007/06/subprime-mortga.html (June 24, 2007, 23:20 EST).

196 *Id.*

critics contend that only regulation of fraudulent lenders and brokers is needed, and, because such laws already exist, no new legislation is required.[197]

Central to each of those arguments is the notion that market forces are sufficient to correct any current pitfalls. However, the market only truly works if borrowers are educated and fully understand the product they are purchasing and the terms those loans include. Unsophisticated borrowers who do not understand the terms of their loans—despite, for example, a disclosure statement buried in the closing paperwork—do not fully understand the true cost of their loan and how little of their home they will actually own.

Such underinformed borrowers do not make up an effectively self-correcting market. To the contrary, that market has created a situation where families continue to lose their homes and destroy the credit they were trying to build. This situation is especially devastating considering its long-term effects. It takes an average of ten to fourteen years for homeowners to reenter the market after relinquishing homeownership[198] due to the debt and injury to credit caused by foreclosure.

Additionally, homeowners and investors do not necessarily learn from others' past mistakes. The savings and loan crisis of the 1980s is an example. The federal government's deregulation of the savings and loan industry allowed thrifts[199] to make riskier

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197 *Id.*; *see also* Greg Farrell, *Former Bear Stearns Hedge Fund Managers Charged*, USA TODAY, June 19, 2008, http://www.usatoday.com/money/industries/brokerage/2008-06-19-bear-stearns-execs-charges_n.htm (reporting on two former Bear Stearns hedge fund managers accused of conspiracy and fraud by prosecutors); Kevin Johnson, *Mortgage Fraud Probe Snares 406 Suspects*, USA TODAY, June 16, 2008, http://www.usatoday.com/money/economy/housing/2008-06-19-mortgage-fraud-arrests_n.htm (reporting on the Justice Department's arrest of 406 individuals—including attorneys, real estate agents, developers, loan brokers, and appraisers—who allegedly profited from housing scams).

198 U.S. DEP'T OF HOUS. & URBAN DEV., THE SUSTAINABILITY OF HOMEOWNERSHIP: FACTORS AFFECTING THE DURATION OF HOMEOWNERSHIP AND RENTAL SPELLS 43 (2004), *available at* http://www.huduser.org/publications/pdf/homeownsustainability.pdf. The study reports that whites take 10.7 years to reenter the housing market while African Americans take 14.4 years and Hispanics 14.3 years. *Id.* The time spent out of the housing market depends on a number of different variables, including family size, weeks worked, weeks unemployed, age, marriage status, and sex. *Id.*

199 Thrifts are federally or state-chartered for-profit saving associations. They are regulated by the FDIC and the Department of the Treasury through the Office of Thrift Supervision ("OTS").

loans in order to remain profitable during the high interest rate and inflationary period in the late 1970s and 1980s.[200] Thrifts poured money into the commercial real estate market, even though many of the loans were risky, oversaturating the commercial real estate market.[201] This oversaturation resulted in many individuals defaulting on commercial real estate loans, causing thrifts to fail with them.[202]

The residential real estate market is in a similar situation now. Lenders and brokers gave individuals risky loans, allowing those borrowers a greater opportunity to purchase property and thereby stimulating demand for housing. This increased demand caused home prices to increase at unsustainable rates.[203] Now, as homeowners begin to cash out their equity at the same time as a substantial number of other homeowners default or sell their homes to avoid defaulting, the residential market has become oversaturated with homes that are quickly losing value.[204]

Additionally, similar to thrifts, many subprime lenders are having financial problems as many of the mortgages they issued are ending in foreclosure. For instance, Bank of America, the second-largest bank in the United States, took more than a $3 billion write-down[205] due to its losses on subprime loans.[206]

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200 Paul T. Clark et al., *Regulation of Savings Associations Under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989*, 45 BUS. LAW. 1013, 1020–22 (1990).

201 *Id.* at 1020–21.

202 *Id.* at 1020–22.

203 OFFICE OF FED. HOUS. ENTER. OVERSIGHT, U.S. HOUSE PRICES CONTINUE TO RISE RAPIDLY 1–3, 8–9 (2005), *available at* http://www.ofheo.gov/media/pdf/1q05hpi.pdf. The average home price increased 12.5% between the first quarter of 2004 and the first quarter of 2005. *Id.* Housing grew substantially faster than the rest of the consumer price index, which only grew at a rate of 3.1%. *Id.* While Oregon's housing prices increased 12.9%, other areas of the country saw a much steeper price increase. For example, Nevada, the District of Columbia, and Florida housing prices increased 31.22%, 22.21%, and 21.42% respectively in a single year. *Id.*

204 Standard & Poor's, *supra* note 26. For example, the average home in Sarasota, Florida, and Reno, Nevada, lost $87,800 and $69,400 respectively between 2005 and the second quarter of 2008. *See* QUARTERLY REPORT, NAT'L ASS'N OF REALTORS, MEDIAN SALES PRICE OF EXISTING SINGLE-FAMILY HOMES FOR METROPOLITAN AREAS (2008). The average home price decreased in San Francisco, Minneapolis, and Portland, Oregon, by $161,500, $16,300, and $12,200 respectively in the year-ending second quarter of 2008. *Id.*

205 A write-down reduces the book value of an asset when it is overvalued compared to the true market value of the asset. This is usually reflected as an expense on a company's income statement, reducing net income. A write-down

Merrill Lynch, the nation's largest brokerage firm, was forced to write down $7.9 billion during the third quarter of 2007.[207] Finally, UBS took a write-down of $3.7 billion from subprime loan losses during the third quarter of 2007 and another $10 billion on December 10, 2007.[208] Even Barclays in London took a $2.7 billion write-down as a result of the subprime loan crisis in the United States.[209]

The high default rate of subprime loans has led the federal government to bail out several companies. First, the federal government seized control of Fannie Mae and Freddie Mac, the nation's two largest mortgage finance companies, at an estimated cost of more than $25 billion.[210] Approximately one week later the federal government loaned American International Group, Inc., ("AIG") $85 billion in an attempt to stop AIG from collapsing.[211]

differs in form from a write-off, which is a deduction for business expenses. *See, e.g.*, JOHN DOWNES & JORDAN E. GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS 793 (6th ed. 2003).

206 For instance, J.P. Morgan Chase & Co. had taken more than $6 billion in write-downs through July 2008 and announced in August 2008 that it would take another $1.5 billion write-down due to its losses on subprime loans. David Weidner, *J.P. Morgan Troubles Emerge with $1.5 Billion Write-Down*, WALL ST. J., Aug. 13, 2008, at C3, *available at* 2008 WLNR 15176720.

207 Joe Bel Bruno, *Mortgages Cause $7.9B Write-Down, Loss at Merrill Lynch*, USA TODAY, Oct. 24, 2007, http://www.usatoday.com/money/companies/earnings/2007-10-24-merrill_N.htm.

208 Mark Landler & Julia Werdigier, *UBS Records a Big Write-Down and Sells a Stake*, N.Y. TIMES, Dec. 11, 2007, http://www.nytimes.com/2007/12/11/business/worldbusiness/11bank.html. UBS is one of the leading international financial firms. Its world headquarters are in Switzerland; its North American headquarters are located in New York, New Jersey, and Connecticut.

209 Julia Werdigier, *Barclays to Make $2.7 Billion Write-Down*, N.Y. TIMES, Nov. 16, 2007, http://www.nytimes.com/2007/11/16/business/worldbusiness/16barclays.html.

210 Stephen Labaton & Edmund L. Andrews, *In Rescue to Stabilize Lending, U.S. Takes over Mortgage Finance Titans*, N.Y. TIMES, Sept. 8, 2008, at A1.

211 AIG's problems are a little different from those of investors and lenders. AIG got itself into financial problems by insuring mortgage-backed securities for investors. *See* Edmund L. Andrews et al., *Fed's $85 Billion Loan Rescues Insurer*, N.Y. TIMES, Sept. 17, 2008, at A1. AIG's insurance contracts required them to put up collateral to guarantee AIG could pay off investors' claims. In early September 2008, credit rating agencies cut AIG's credit ratings due to the declining value of the assets that AIG used to guarantee the insurance contracts. These contracts required AIG to put up more assets to cover the decline in original asset value. However, AIG did not have enough assets to fulfill this obligation. Thus, in an attempt to protect investors who bought insurance from AIG, the federal

Most troubling of all may be the financial problems suffered by investment bank and brokerage firm Bear Stearns. Bear Stearns, which had already written down more than $1 billion in mortgage-related securities, was forced to accept a purchase offer from fellow financial services firm J.P. Morgan Chase of only $2 a share when its stock had been selling for $170 per share only a year earlier.[212] If highly educated businesses and lenders have not learned from their own mistakes in making risky loans, borrowers are even less likely to do so—especially if the federal government has to bail out companies for making bad business decisions.[213]

If market forces cannot be relied upon to force lenders to self-correct, the federal government needs to step in, provide a fix for the high foreclosure rates, and ensure another savings and loan or subprime crisis does not happen in the near future. The federal government's regulation of the subprime market will ensure lenders practice safe underwriting standards and lend only to those individuals who have the financial resources to pay off their loans.

VI
HOW TO FIX THE CURRENT SYSTEM

For federal and state governments to truly achieve the objective of protecting and creating educated borrowers, regulators need to realize that securitization has changed the

government made a two-year, $85 billion loan to AIG. The loan can be converted to common stock if existing shareholders approve. If converted to common stock, the federal government would own eighty percent of AIG. *See id.*

212 Andrew Ross Sorkin, *JP Morgan Pays $2 a Share for Bear Stearns*, N.Y. TIMES, Mar. 17, 2008, http://www.nytimes.com/2008/03/17/business/17bear.html.

213 *See* H.R. 1424, 110th Cong. (2008) (containing a $700 billion bailout package for the U.S. financial markets); The Mortgage Implode-O-Meter Home Page, http://ml-implode.com (stating that 293 major U.S. lending institutions have "imploded" since 2006) (last visited Oct. 20, 2008).

The bailout plan allows the Secretary of the Treasury to purchase up to $700 billion in mortgage-related assets. It is not my position that the bailout is bad. It may be necessary to stop the U.S. economy from a recession or even a depression. However, it is my position that such a proposal will limit the pain felt by wealthy investors where it hurts the most: their bank accounts. There is no incentive for investors to self-correct unless they know they will not be bailed out for creating such risky investments. If the law allows them to create risky investments, most likely, they will create risky investments. Because the government has stopped the market from self-correcting, regulations must accompany any bailout plan.

mortgage transaction market. None of the regulations currently in place fills the substantial disparity in education, experience, and access to information between borrowers on one side, and lenders, brokers, and investors on the other.[214] Creating a more even playing field between the parties can be accomplished by imposing an agency duty on brokers,[215] eliminating the holder in due course doctrine, and requiring MERS to disclose more information to borrowers. Without such measures, circumstances will be ripe for another subprime crisis to occur.

Furthermore, brokers cannot be trusted to create educated borrowers because brokers have monetary incentives to ensure borrowers remain uninformed and accept the most expensive loan possible.[216] As long as this incentive exists, brokers will disclose *only* the required information and will do so in an uninformative manner.[217]

Brokers are not the only party that benefits from uniformed borrowers. Lenders, investors, and others involved in the securitization process also benefit financially from issuing the most expensive loans possible. This kind of market will never

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214 Wilson, *supra* note 67, at 1493–94.

215 I understand that this often is considered an issue for individual states. However, now that Wall Street securitizes these loans and mortgage transactions across state borders, the issue is one of federal law as well.

216 Eggert, *supra* note 38, at 553. In fact, many brokers are refinancing borrowers' prime loans into unfavorable higher interest rate loans. *See* Cathy Lesser Mansfield, *Predatory Mortgage Lending*, 1242 P.L.I./Corp. 9, 41 (2001).

217 Wilson, *supra* note 67, at 1500–01. Professor Wilson gives five examples of providing the required information in an uninformative way. First, a broker can use language that a majority of individuals do not understand, such as "ysp" instead of "yield spread premium." Second, a broker can tell borrowers that the language on a form is just standard boilerplate language. Third, a broker can provide nonresponsive answers that likely will not be questioned due to a borrower's insecurities about appearing uneducated. Fourth, a broker can convince a borrower that it is too late to change the terms or threaten to cancel the closing. As Professor Wilson points out, this can be very effective because most subprime borrowers do not think they would qualify for a loan through another lender. Finally, a broker can have the borrower sign a disclosure form with one or more blanks. The broker then fills in the blanks after the closing. This is significant because a borrower will then have to demonstrate he did not received proper disclosure forms even though the document has his signature on it.

It may be argued that borrowers should know not to sign an incomplete document. However, the policy behind the federal regulations is to make sure borrowers receive and understand all of the crucial information concerning their loan. As it stands, this policy is not being achieved under current regulations. Therefore, there is a need to figure out other ways to achieve this policy.

ensure that borrowers are educated, as there is no financial incentive to educate them. Borrowers need someone in the process to represent their interests in these non-arms-length transactions (i.e., failure to have equal bargaining power and equal information regarding the transaction between the parties). Brokers are in the best position to accomplish this goal.

Brokers should have a duty imposed upon them that aligns their interests with those of borrowers.[218] Imposing an agency responsibility on the broker—with the borrower as the principal—will ensure either that the borrower is educated enough to make a well-informed decision or that the broker will act in the borrower's best interest.[219] Further, this agency relationship should bar brokers from being compensated by the lender or purchaser of the loan. Instead, a broker and a borrower should arrange a fee agreement prior to the broker performing his job of finding the borrower an appropriate loan. Requiring the borrower to pay the broker directly is not a detriment to the borrower; the borrower already indirectly pays the broker through fees and yield spread premiums.[220] Doing so will ensure that the broker represents the borrower's interest first, not their own bank accounts. In a number of states, including Oregon, real estate brokers have an affirmative duty to deal in good faith and not act detrimentally or adverse to their clients' interests.[221] This same requirement should be placed on mortgage brokers arranging the financing.

Imposing an agency duty will also make it difficult for brokers to take advantage of unsophisticated borrowers because such a relationship changes the evidentiary burden for borrowers who assert claims against brokers. Borrowers will not have the burden of proving the existence or nonexistence of disclosures if a borrower tries to assert a claim or defense against the broker.[222] Instead, with an agency duty the court will focus on

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218 *Id.* at 1503–19.

219 *Id.* at 1512–13.

220 *Id.* at 1513–16.

221 OR. REV. STAT. §§ 696.805–822 (2007); *see also* Ronald Benton Brown et al., *Real Estate Brokerage: Recent Changes in Relationships and a Proposed Cure*, 29 CREIGHTON L. REV. 25, 84–97 (1995).

222 Wilson, *supra* note 67, at 1518–19 (discussing the difficulty of overcoming this standard because many brokers will sneak the documents into the papers to be signed by borrowers without ever making the proper disclosures).

whether the disclosures were made in a manner that would reasonably be expected to inform the borrower and whether the loan terms were in the borrower's interest.[223] This change would give brokers the incentive to make sure borrowers understand the terms in the loan, exercise due diligence in finding an appropriate loan for the borrower, or both. In either scenario, the borrower likely is not injured and the broker has the incentive to perform his job as he should already be performing it. Some brokers will exit the marketplace, but the brokers remaining in business will likely be more trustworthy and help individuals find affordable loans.

While placing a duty on the broker will help ensure that a borrower is well informed, regulations also need to eliminate the holder in due course doctrine and require MERS to furnish the original note prior to foreclosure. As described above, HOEPA fails to apply to most subprime loans, and there is no assignee liability for mortgage notes because the holder in due course doctrine shields buyers and assignees of a loan from a borrower's claims.[224] As a result, a borrower will only be able to seek redress against the broker or original lender. This is an inadequate remedy for two reasons. First, the broker or originator likely has closed or gone out of business.[225] Second, the broker or lender may have inadequate assets to make the borrower or group of borrowers whole.[226]

Furthermore, eliminating the doctrine from subprime mortgage transactions would be consistent with the Federal Trade Commission's regulation that eliminates the doctrine for loans made for the acquisition of goods and services.[227] This

223 *Id.* at 1519.

224 U.C.C. §§ 3-301–304 (2007); JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 508–09 (5th ed. 2000).

225 *See* Peterson, *supra* note 36, at 2270–73 (noting that brokers and lenders have learned to set up businesses, flip as many loans as possible and quickly disappear, leaving consumers with no remedies).

226 Eggert, *supra* note 38, at 546–47 (noting that with securitization of the loan industry, originators are able to lend more money than they have assets to cover any potential claims).

227 *See* WHITE & SUMMERS, *supra* note 224, at 536–38. This raises several interesting issues likely to arise when the subprime loan crisis, and the number of resulting lawsuits, really explodes. First, it will be interesting to see if borrowers argue that the holder in due course doctrine does not apply to all of the refinance loans that were used to purchase cars, vacations, or used for home improvements.

would allow borrowers to seek redress against the owner of their loan and shift the risk of loss to the parties making money from the transaction—after all, that higher risk of loss is supposedly why the borrowers are paying a higher interest rate. Without assignment liability, investors are receiving a profit windfall. The doctrine provides a shield from any costs associated with borrowers' claims while giving investors a sword to recover all the financial benefits of the loan.[228] Additionally, due to their knowledge, investors are in a better position than consumers to detect fraud and wrongdoing and thus are in a better position to bear the risk of loss.[229] Removing investors' ability to hide behind the doctrine will force them to exercise greater due diligence in examining the loans because they will bear the risk of loss. This will likely decrease investors' demand for risky loans and increase demand for higher quality loans, leading originators and lenders to stop issuing risky loans that they will no longer be able to sell on the securities market.

In addition to eliminating the holder in due course doctrine, MERS should be required to notify borrowers when their loan is reassigned, and be required, along with every note holder, to produce the original note prior to foreclosure.[230] Without these requirements, MERS will shield note holders because borrowers will be unable to discover who owns their loan and against whom to pursue a legal claim. Additionally, in a number of foreclosures, MERS has been able to proceed without providing the original note.[231] The original note can provide valuable information for a borrower's claim or defense in a foreclosure.[232] Without this information, investors could still be *de facto* shielded from liability even though the holder in due course doctrine is eliminated. This will ensure investors cannot hide behind MERS and will provide further incentives for investors to exercise due diligence in reviewing loans before they purchase them.

Second, it will be interesting to see if courts in anti-deficiency states allow anti-deficiency laws to protect borrowers that received these types of refinancings.

228 Clayton P. Gillette, *Holders in Due Course in Documentary Letter of Credit Transactions*, 1 ANN. REV. BANKING L. 21, 36 (1982).

229 *Id.* at 48.

230 Peterson, *supra* note 36, at 2266–67.

231 *Id.*

232 *Id.*

Another improvement upon current regulations is illustrated by the use of high "trigger" rates. As described above, current federal regulations often encompass only a small percentage of subprime loans. Lenders are more than willing to charge fees and interest rates slightly below the trigger rates in order to keep risky provisions in the loans, avoid certain disclosure rules, and keep assignment liability out of the loan. While the federal monetary agencies have taken a step in the right direction in encouraging greater disclosure, those agencies have a limited reach over lending institutions. A better way to create educated borrowers would be to impose an agency relationship on brokers and take away any incentives a broker has to give borrowers the most expensive loan possible.

CONCLUSION

Predatory lending practices, a complex and slippery system of loan securitization, and ineffective state and federal regulations have all combined to create an environment in which borrowers are underinformed, taken advantage of, and left with inadequate tools to assert their rights. Most troubling of all, the regulations currently in place will do little in the long run to prevent crises from occurring in the future.

Both federal and state regulations must be vastly improved to address the problems that have arisen, and will continue to arise, from subprime lending. The subprime loan market is too complex and smart for quick fixes. Regulations will have little effect if lenders remain able to sidestep regulations by charging interest rates just below the trigger rates; borrowers cannot depend on being educated by brokers who have monetary incentives to ensure that borrowers stay *un*informed and accept the most expensive loans possible; and the American public cannot regain solid footing if the subprime market continues to push loans that are of poorer quality than borrowers deserve and more costly than borrowers can repay.

The current patchwork of legislation would best be overhauled by a single set of comprehensive federal regulations. Several elements are critical to such a regulatory change, including the prohibition of particularly unfavorable subprime provisions (such as negative amortization) except in limited circumstances, the imposition of an agency relationship on

brokers, the elimination (or significant limitation) of the holder in due course doctrine for residential mortgages, and the requirement that note holders produce original loan documents upon assignment. Crucially, the restriction and regulation of subprime provisions must apply to *all* residential mortgages, not just high-cost loans.

After the dust settles from the current subprime meltdown, adopting these broader and stronger protections will help to ensure another crisis does not arise anew. To instead forget the lessons this crisis has taught—just as investors forgot the lessons of the Savings and Loan crisis—would be more costly than the nation's economy can afford.